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Foreign Economic Trends and Their Implications for the United States

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FINNISH KEY ECONOMIC INDICATORS

Values in US$ millions unless otherwise indicated. Exchange rate, $1.00: 1987 = FIM 4.404; 1988 = FIM 4.191; 1989 = FIM 4.25 (e) = estimate

	1987	1988(1)	% Change(2)	1989(e)	% Change(e)
INCOME, PRODUCTION & EMPLOYMENT					
GDP* (current prices)	89,347	104,497	11.3	112,320	9.0
GDP* (constant prices)	81,190	89,408	4.8	91,250	3.5
Per capita GDP* (dollars)	18,116	21,128	11.0	22,636	8.6
Industrial fixed investment (manufacturing industry)	3,775	4,404(p)	11.0	4,775	10.0
Private disposable income	48,705	54,154	5.8	56,070	5.0
Industrial production(1980=100)	122.2	127.1	4.1	130.9	3.0
Avg. industrial wage (hrly. rate for males, $)	8.90	10.09	7.9	10.65	7.0
Labor force (000's)	2,554	2,546	-0.3	2,546	0.0
Avg. unemployment rate, percent	5.1	4.5	0.3	4.0	-0.5
MONEY AND PRICES					
Money supply, M2	45,517	58,871	23.1	63,850	10.0
Base rate, Bank of Finland	7.00	7.67		7.8	
Wholesale prices (1980=100)	98.7	102.2	3.5	106.3	4.0
Consumer prices (1985=100)	107.1	112.6	5.1	119.4	6.0
Retail sales (1980=100)	123.0	129.0	4.9	135.0	4.5
BALANCE OF PAYMENTS AND TRADE					
Gold and foreign exchange reserves, Bank of Finland	6,495	7,040	3.2	6,945	0.0
External central govt. debt	6,512	6,270	-8.4	5,874	-5.0
External debt service ratio (total external debt) (3)	13.2	12.5		13.0	
Bal. of pymts., current acct.	-1,930	-3,007		-4,000	
Balance of trade	615	187		-340	
Exports, f.o.b.	19,418	22,167	8.6	23,610	8.0
U.S. share, percent	5.2	5.8		6.0	
Imports, c.i.f.	18,803	21,980	11.2	23,950	10.5
U.S. share, percent	5.2	6.4		6.2	

* Gross domestic product

e = estimate; p = preliminary
1) Exchange rate changes have distorted some growth trends.
2) Percentage changes based on FIM values.
3) Debt service charges on net debt as percentage of current account earnings.

Main imports from United States, Jan.-Dec. 1988 ($ millions): Machinery & equip., 559 (of which office machinery & ADP equipment, 282); aircraft & parts, 164; chemicals & related products, 120; precision instruments (measuring & controlling equipment, medicinal & optical instruments, etc.), 69; foods, 52; road vehicles & parts, 49; oilseeds, 32.

SUMMARY

The Finnish economy is rapidly getting out of equilibrium as output growth is increasing based on domestic demand. This has led to a strong import growth and has diverted resources from the export sector, which now operates near or at capacity. This continuing economic boom has confounded forecasters, who had predicted a slowdown. In 1988, real GDP increased 4.8 percent, compared with a healthy 3.6 rise in 1987, but it should drop back to the 3.5-3.8 percent range this year.

The outlook for economic activity is generally bright, but there are less favorable warning signs. Demand has outstripped the ability of industry to keep up, pushing manufacturing to the limits of capacity and the current account into deficit. Inflation rose to 5.1 percent for 1988 as a whole, and 6.5 percent year-on-year through December 31. Failure to moderate wages and an unemployment rate projected to drop from 1988's already low 4.5 percent to 4 percent this year will only be partially offset by gradually moderating consumer demand. This is expected to yield an annual average consumer price index (CPI) increase of 6 percent.

Policy-makers are concerned with the longer term implications for the external competitiveness of the economy of inflation rates which are well above average for the Organization for Economic Cooperation and Development (OECD). Also worrisome is the shift of the prime engine of economic growth from the export sector to domestic demand, reflecting economic growth which is also well above OECD levels. Measures undertaken so far include an unorthodox revaluation of the Finnmark, intended to act as a temporary drag on export sectors operating near or at capacity, and fiscal measures to dampen domestic demand.

Prospects for the twin pillars of the manufacturing sectors, the forest and metal-related industries, are good both for export and domestic markets. The forest industries turned in record-breaking performances in 1988, while the metals and metal-engineering companies continued to do well while reorienting themselves from Soviet markets.

In the external sector, Finland's current account deficit sank by $1 billion to a $3 billion deficit. The causes were the transition from surplus to deficit in the merchandise trade account, an increasing debt service burden, and a services account which seems now to be endemically in deficit. The outlook for 1989 is more of the same, with the current account deficit reaching $4 billion. While it is not at the critical stage, policy-makers will be looking for ways to bring price and demand developments back into equilibrium.

CURRENT ECONOMIC SITUATION

Economic Growth: Last year's forecast of a turndown in the Finnish economy continues to be placed further into the future by both government and private economists. With domestic demand still buoyant, and aided by an upturn in private investment, the rate of Finland's real GDP accelerated to 4.8 percent, the fastest growth since the boom of 1979-80. Private consumption is likely to remain the engine of growth again in 1989, supported by industrial investment, but at slightly lower rates than in the previous year. The current consensus of the Finance Ministry and most of the economic research institutes is that the economy will post a robust gain of 3.5 percent in 1989, some 0.5 percentage points above the OECD average. Slower but still strong growth, on the order of 2.5 to 2.8 percent, is predicted for 1990 as domestic demand moderates and investments slacken.

The mainstay of the economy, the forest industries, should continue to perform well in 1989, although the sector is pushing at capacity in terms of labor and raw timber availability. The industry turned in record-breaking profits in 1988 and is ambitiously expanding facilities in anticipation of increased export demand. Total pulp and paper output is predicted to rise 5 percent in volume this year, almost 2 percentage points more than in 1988. Export markets for lumber and plywood are expected to soften, but domestic construction activity should sustain production. Saw mill profitability will be eroded by substantial increases in stumpage prices. On the whole, forest industry output in 1989 is expected to rise by approximately 4.5 percent, 2 percentage points less than the year before.

Demand outlook in basic metal, metal manufacturing and engineering industries remains favorable both in domestic and Western markets, while deliveries to the Soviet Union will contract noticeably. Due to growth in heavy machinery, industry order bookings were above normal at the beginning of 1988, causing longer delivery times. World markets and prices, good since 1987, should be favorable for the next 12 months. As in the forestry sector, machinery and metal products output has that sector operating at almost full capacity. Capacity constraints have caused a number of foreign orders to be shifted to offshore subsidiaries. The situation in shipbuilding is fairly good, but with pronounced negative trends: orders on hand at Finnish shipyards totaled 602,684 GRT at the end of 1988, 61,881 GRT less than in 1987. Industry specialists expect production to contract substantially in 1990. Overall, the total output growth of metal sectors is projected to fall from 7.5 to 4.5 percent in 1989.

Production by other manufacturing industries is projected to rise about 3.5 percent in volume. Brisk residential construction will boost the output of construction materials industries. The chemical industry's outlook is favorable as demand for industrial chemicals is supported by the activity in the forest industries. Production growth in foodstuffs industries is static, while output continues to fall in the clothing and footwear industries, although at a slower rate than last year. Overall, manufacturing growth is estimated to decline from 4.6 percent in 1988 to about 3.5 percent in 1989, with aggregate industrial production declining correspondingly from 4.1 to 3 percent.

Fiscal Policy: Riding on the crest of an extended period of economic boom, Finland's economy is straining against the country's labor and raw material capacities. The boom in domestic consumption and investment was sparked by liberalization in financial markets, resulting in a rapid accumulation of household debt, a fall in the domestic rate of private savings, and a run-up in the country's payments deficit as domestic production has not been capable of keeping pace with demand. The overall growth in aggregate output has been driven by domestic demand, which has diverted capacity from meeting export demand. The emergence of a serious current account problem during an economic upswing has haunted decision-makers as it lessens the room for maneuver should a recession occur.

The thrust of overall economic policy was changed starting in January 1988 with the above situation in mind. The initial focus was on restraining consumption and dampening business activity utilizing a variety of measures, inter alia, a tax on new construction activity, collection of mandatory deposits from corporations, and higher nuisance taxes on tobacco, alcohol and gasoline. In connection with drafting of the 1989 national budget, a comprehensive economic stabilization agreement was concluded which was intended to induce wage moderation in labor markets through linkages to tax reforms.

As inflation kept climbing and the current account deepened, the government and the Bank of Finland presented an unorthodox package of policy measures in March 1989. It combined a 4 percent revaluation of the Finnmark with increases in the turnover tax to 16.5 percent and higher employer sickness insurance contributions. The intended impact is for the revaluation to dampen activity in the export sector, with the higher sales tax offsetting the effect on import demand, and reduced labor demand by employers. Government officials hope that some $300-$350 million will be withdrawn from Finland's overheated economy through these measures.

Overall fiscal policy in 1988 had a mildly contractionary impact on the economy, restraining GDP growth by about 1 percent. This was accomplished by indexing income tax brackets less than actual inflation. With increased indirect taxes and brisk economic activity, government revenue increased faster than spending, yielding a considerable improvement in the government's financial position. This led to a decline in central government debt in nominal term to FIM 58 billion ($13.9 billion) at the end of 1988, equivalent to 13.3 percent of GDP. This ratio should fall again in 1989 to 12.5 percent as revenue again outpaces spending, with the overall budget showing a surplus. However, the consolidated public sector budget in 1989 will have a mildly stimulative effect on the order of 0.5 percent in GDP growth due to rapidly increasing spending by local governments.

In our judgment, the gradual tightening of fiscal policy measures comes rather late in the game and with only superficial impact. Characteristically, the delicate political balance which exists among the government and labor market organizations makes effective wage restraint impossible. There is also a lack of controls over local governments' spending, and policy-makers are counting on the Bank of Finland to restore equilibrium to the economy through monetary policy.

Monetary Policy: The operating environment for monetary policy in Finland has been severely circumscribed both by domestic financial liberalization and exchange rate policy, and by external pressures for liberalization of capital movements. These include Sweden's recent removal of capital controls and the EC 1992 process. Progressive liberalization of monetary markets in recent years has reduced the Central Bank's policy instruments. Efforts over the past 12 months to limit credit growth and economic activity through higher interest rates proved ineffective. Total credit extension by banks rose 30 percent last year, pumping inflationary purchasing power into the economy. This was explained by the residual effects of removal of credit rationing several years ago and a one-time burst of company and real estate transactions spurred by the 1988 tax reform. As part of the economic stabilization package of 1988, the Central Bank yielded to political pressure in reducing its base rate by 0.5 percentage point. However, the effect of changes in the base rate are negligible in the current financial market environment. To give itself more room for policy maneuver, the Bank of Finland expanded the fluctuation band of the Finnmark index from 4.5 to 6 percent in late November 1988.

Alarmed at rapidly increasing consumer debt, the Bank of Finland took a step back from financial liberalization in forcing an agreement on banks to supplement the existing cash reserve agreement. It can now raise the cash reserve requirements of a particular bank or banking group, should lending by that group increase by more than 20 percent during the period of February 1 to December 31, 1989. In addition, the Bank of Finland issued recommendations to banks regarding their credit extension. Subject to hardest pruning will be consumer credits and home and real estate loans.

Interest rate tools have been rendered ineffective by relaxed capital controls. Higher rates in Finland tend to attract foreign capital, with corresponding increases in domestic liquidity and depressing domestic interest rates. Nonetheless, should the government's and the Bank of Finland's joint measures fail to cool off price pressure, the Central Bank can resort to increasing the base rate, which would be politically inexpedient and somewhat ambiguous in impact. Interest rates rose sharply in early 1989, 150 basis points between March and May alone, due to the March Finnmark revaluation and tighter bank liquidity.

Investment: In 1989 total fixed investments could rise 8.5 percent in volume, after an increase of 10.5 percent in 1988, boosted by brisk residential housing outlays. Residential housing construction continues in high gear although total starts are beginning to decline. Spurred by ongoing structural adjustment in industry, outlays for capital goods have increased with heavy emphasis on automation and ADP machinery to cope with the tight labor market. Forest industry outlays show signs of leveling off while those of metal manufacturing and engineering industries are still gathering strength. In the forest industry, a major proportion of the investments are for capital stock renewal, which will not significantly increase capacity. Sector concentration continues, as the industry gears up to cope with European integration. At present, one-fifth of Finnish forest industry's total production capacity is located abroad. In other industrial branches, investment volume declined, although at a lower rate than last year. As in 1988, investments increase more rapidly in private companies, but with some improvement among the state-controlled companies. The high rate of capacity utilization and strong demand keep industry's finished goods inventories low again this year. Growth in public investments should slow or stop in 1989 as the government postpones projects as part of its counter-cyclical program.

R&D expenditures last year rose at a faster pace than fixed investment, and the same trend is expected to persist this year. Nevertheless, this is lower than in most other OECD countries, equaling less than 2 percent of GDP.

Domestic Consumption: Private consumption in 1988 rose 5 percent by volume, the same as the year before, but it should drop in 1989 to 3.5 percent. In the 1980s, consumption has far outpaced growth in disposable income, due to relaxed credit controls. The disposable real incomes of households grew only 1.5 percent and the savings rate dropped to 0.5 percent. The total debt of households in relation to their disposable incomes rose by nearly 13 percentage points to over 80 percent, with interest payments alone equaling 7 percent of household income. The savings rate should not fall any more as new forms of money market investments appear. On the other hand, the propensity to consume remains high and travel abroad will increase. Public consumption growth is projected to decelerate from 3.5 percent in 1988 to some 3 percent in 1989. Overall, the ratio of consumption to GDP this year is projected at 74 percent, the same as in 1988.

Inflation: Finland's inflation crept up again above both the OECD and the Nordic average. As measured by the CPI, inflation in 1988 rose at an 5.1 percent annual rate; the increase from December 1987 to December 1988 was 6.5 percent. For 1989, the annual average inflation rate may reach or exceed 6 percent, almost 1.5 percentage points above the OECD average. A positive sign is that the December-on-December increase will drop to 5 percent. This will, however, trigger the automatic wage-compensation clause of the current labor contracts. Primary factors in the CPI include higher housing costs, indirect taxes and charges, and labor costs. This will have and adverse impact on Finland's external competitiveness.

Labor: Labor demand in 1988 resulted in the creation of about 8,000 new jobs, mainly in the service sector. Spurred partly by the new employment law, new work places also increased in the public service sector. A sign of extensive structural adjustment, the industrial labor force contracted by some 16,000 jobs in 1988, for a total of 45,000 fewer over the past 3 years. In addition, labor reductions were experienced in both agriculture and forestry. As the labor supply also declined due to demographic trends, average unemployment fell from 5.1 percent in 1987 to 4.5 percent in 1988, and may drop to 3.8 percent by the end of 1989. These numbers translate into severe shortages of skilled labor--mainly in metropolitan areas--which constrains increased industrial output and fuels inflation.

Finnish Exports: Finnish export growth acceleration in 1988 was attributable to last minute arrangements in Fenno-Soviet trade. These made previously contracted Finnish exports possible despite the continued imbalance in bilateral trade. Exports to OECD destinations increased as well, but at a slower pace than in 1987. Although novel payments arrangements are in the works, Finnish deliveries to the USSR will fall 9 percent in volume this year, after showing a slight gain in 1988. Demand in Western markets is expected to remain high, sustained by the capacity made available by decreasing trade with the Soviets. This redirection of trade is not friction-free, as export growth to the West is hampered by deterioration in Finnish industry's external competitiveness. Finland's Western deliveries are projected to rise 4 percent in volume, the same as in 1988, with the growth in total Finnish exports in 1989 projected at 2.5 percent in volume, down from 4 percent in 1988.

Exports by Finnish forest products industries, the major industrial sector, rose by nearly 10 percent in value last year, equaling nearly 42 percent of total exports. Since there are no signs of softening foreign demand, export growth may be expected to continue also this year, supported by new capacity. Market watchers note that capacity in competing nations is also growing, which suggests a less rosy outlook towards the end of the year.

Boosted largely by deliveries of ships and papermaking machinery, the value of shipments by the various metal sectors rose by 6 percent, equivalent to 39.3 percent of total exports. In 1989, these exports are projected to stay at last year's level, although shipments to the Soviet Union will decline. Despite a higher interest rate environment, investment activity in Western markets should continue, boding well for demand for Finnish goods. In other industry sectors, especially textiles, footwear and foodstuffs, the need to balance trade with the Soviet Union will cause export performance to continue to fall.

Import Demand: Strong domestic demand in 1988 could not be met by domestic production, causing import volume to jump 9 percent in volume terms, the same as the year before. Both consumer and investment goods imports rose substantially. This has been exacerbated by price developments at home. In 1989, the import increase should level off as domestic demand abates, with import volume growth dropping to 6.5 percent. Sustained by ample household liquidity, consumer goods, especially durables, will be imported in higher numbers. The import of investment goods is predicted to increase at a lower rate than last year, although the demand for products such as data processing and office

machinery cannot be met by domestic production. Heavy investments by metal manufacturing and engineering industries also require imported machinery and equipment. Purchases of raw materials and production goods are forecast to slow down in response to a lower pace of aggregate industrial output.

Balance of Payments: Finland's external balance has weakened in recent years due to heavy import demand and imbalances in Fenno-Soviet trade. The 1986 merchandise trade surplus of FIM 5 billion ($1 billion) fell to only FIM 1 billion ($239 million) in 1988 and will shift to a FIM 1 billion deficit this year. Similarly, in the services accounts the traditional surplus reversed into a deficit of FIM 1.3 billion ($310 million) last year as all major items weakened. In addition, increased debt-service payments account for almost 66 percent of the total current account gap. While improved terms of trade have softened the overall impact, the current account deficit deepened from FIM 8.[illegible] billion ($1.9 billion) in 1987 to FIM 12.6 billion ($3 billion) in 1988, 3 percent of GDP.

Finland's current account will weaken further in 1989 thanks to the anticipated trade deficit and growing debt service burden. The Finance Ministry projects a payments deficit of FIM 16.5 billion ($3.9 billion) for 1989, 3.5 percent of GDP. Other forecasters believe the gap could reach FIM 20 billion ($4.7 billion). The ratio of Finland's external net debt to GDP will rise from 16 percent in 1988 to 18 percent in 1989. However, Finland does not face a critical situation with its growing debt ratio, as it is low by international standards, and well below the 7 percent reached in the 1970s.

Large inflows of foreign capital are both the cause and product of the current account deficit. A substantial interest rate differential and Finland's fix[illegible] exchange rate policy have sustained inflows of foreign exchange, financing the payments gap. Last year, the Bank of Finland's convertible currency holdings rose by FIM 1.17 billion ($279 million) to FIM 28.56 billion ($6.81 billion). In 1989, convertible exchange reserves peaked in mid-March, and started declining after the Bank of Finland broke with policy and revalued the Finnmark. This has injected uncertainty as to future exchange rate movements, slowing the rate of capital inflows. Official foreign borrowing will not increase, as any public sector financing is planned for domestic markets. The private sector will continue to go abroad for borrowed capital, taking advantage of relatively lower interest rates. Thus, we see no change in the level of official foreign exchange reserves in 1989.

IMPLICATIONS FOR THE UNITED STATES

With a 6.5 percent market share in 1988, the United States ranked as Finland's sixth largest supplier, following West Germany, Sweden, the USSR, Japan, and the United Kingdom. The main U.S. goods exported to Finland are: computers and parts; industrial machinery; aircraft and parts; electrical machinery; and measuring, checking, and analyzing instruments.

The composition of both Finnish imports and exports has shifted over the past decade toward more manufactured goods. In 1977 nearly one-fourth of Finland's imports were petroleum products, but by 1988 this share had declined to 10 percent. Manufactured goods, which accounted for 77 percent of Finnish exports in 1977, rose to 85 percent in 1988, while exports of raw materials dropped from 16 to 13 percent. This trend is likely to continue.

Because the Finnish economy is dependent on maintaining export competitiveness, demand is strong for sophisticated machinery and equipment to keep industries up-to-date. Finland also maintains high standards of medical care and environmental quality.

Opportunities for U.S. business are particularly good for the following product lines: Computers and peripherals, electronic components, electronics industry production and test equipment, telecommunications equipment, business and office machines, medical electronics, automotive parts and accessories, avionics and ground support equipment, pollution control equipment, and industry controls.

The United States, with annual deliveries worth $280 million, is Finland's leading external source of all types of computers and peripherals. U.S. deliveries account for 32 percent of Finland's import market in this field. American predominance in the Finnish market lies deeply entrenched thanks to a long-standing presence of U.S. marketing, maintenance, and training organizations. In order to safeguard this dominant position, U.S. suppliers are well-advised to pay particular attention to meeting the upsurge in demand for microcomputers and microsystems expected to accelerate sharply over the next few years.

Consumer goods have enjoyed high growth as the cheap dollar has made U.S.-origin products very price competitive in the market. The imports of U.S.-made cars, boats, and other consumer products have grown dramatically but may be reaching

the point of market saturation. This is especially true for boats and related equipment. Further growth in the consumer goods area will depend both on the value of the dollar and the continuation of the current splurge in consumer spending.

Finnair, the national airline, has been a customer of McDonnell-Douglas aircraft since the 1940s. The company has placed an order for four new MD-11 wide-body aircraft. The purchases are part of an extensive investment program by the airline. The four MD-11s will cost some $370 million and the investment program some $250 million annually for the next few years. The original order for two aircraft plus options on two others was upgraded to four aircraft on firm order, with options for yet another two.

In the travel sector, boosted both by the cheap dollar and increased disposable income, Finns have been travelling to the United States in ever larger numbers. In 1988, some 74,000 Finns visited the United States, an increase of 43 percent compared with the previous year. Should the Finnmark and the Finnish economy remain strong, we anticipate an increasing share of Finnish tourist spending to be directed to American vacation centers, notably Florida, the U.S. Virgin Islands, and New York.